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Policy Reform is the Best Monetary Reform

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Policy Reform is the Best Monetary Reform

by Allan H. Meltzer

Proposals for monetary reform and international policy coordination are becoming as common as fool's gold. A common theme of these proposals is that fluctuating exchange rates have served us badly.

The belief that fluctuating exchange rates create uncertainty and instability, or depress economic activity, is a myth -- one of many myths about economics that gain acceptance by frequent repetition. Countries can have either more or less uncertainty and instability under fluctuating exchange rates. What happens in practice depends on the policies countries choose and on how reliable and dependable are policymakers' commitments to those policies.

The variability of unanticipated changes in output is a generally accepted measure of uncertainty and costly economic variability. Comparisons using this measure show that Japan and Germany, countries with more stable policies, reduced uncertainty and instability after the shift from fixed to fluctuating exchange rates. The United States and Britain, where policies change frequently, experienced greater uncertainty.

Experience in the U.S. and Japan

The comparative experience of the U.S. and Japan is illustrative. In the fifties and sixties, the Japanese government controlled interest rates, allocated bank credit, and maintained fixed exchange rates under the Bretton Woods agreement. In 1975 a few years after the collapse of fixed exchange rate system, Japan adopted a system of pre-announced monetary projections with fluctuating exchange rates. Later, the government began to deregulate interest rates and the credit market. Until the September 1985 agreement at the Plaza, evidence suggests that generally the dollar - yen exchange rate fluctuated freely.

A stable fiscal plan to reduce budget deficits by reducing the growth of
spending complemented the more predictable monetary policy. Since 1975, inflation has been reduced, fluctuations are smaller and uncertainty is lower. Japan avoided the recession of the early eighties.

U.S. experience differs. The shift from fixed to fluctuating exchange rates was followed by an increase in variability and uncertainty. The U.S. also announced projected rates of money growth beginning in 1975, but instead of announcing a single projection, as in Japan, the Federal Reserve announced targets for several monetary aggregates and gave ranges for each. The Federal Reserve, unlike the Bank of Japan, regularly shifts the base from which money growth is measured. In practice, the Federal Reserve often fails to meet its targets, while the Bank of Japan has kept actual money growth very close to projections. Lack of a coherent and consistent U.S. fiscal policy added to instability and uncertainty.

Both the United States and Japan experienced common shocks—the oil shocks of 1974 and 1979-80, major changes in exchange rates, the Carter shock following imposition of credit controls in 1980 and other surprises. These common shocks are at least as important quantitatively for Japan as for the United States, so it would not have been surprising if uncertainty and variability rose more in Japan than in the United States. In fact, the opposite occurred. Quantitative measures of uncertainty about output for Japan, expressed as a percentage of annual output, declined from 1.9% under fixed exchange rates to 0.7% under fluctuating rates and monetary projections. In the U.S., the same measure of uncertainty rose from 0.8% to 1.2% of output. Price level uncertainty also shows divergent changes in the two countries, a decline in Japan, an increase in the United States.

Japan was able to reduce variability and uncertainty about domestic prices and output both absolutely and relative to the U.S. Much of the reduction was achieved after 1975, during the period of monetary announcements and fluctuating exchange rates in both countries. It seems reasonable to attribute responsibility for the relative and absolute reduction in uncertainty in Japan to the greater stability and credibility of Japan's monetary and fiscal policies in recent years. If Japan's monetary policy had remained tied to the United States, or if Japan had "coordinated" with the United States, Japan would have imported instability and uncertainty from the United States.

The change in policy arrangements provided an opportunity to reduce
inflation and increase the credibility of economic policy. The Bank of Japan achieved rates of money growth close to projections, thereby enhancing credibility, reinforcing its commitment to lower inflation and lowering the cost of disinflation. The growth rate of money declined gradually, but persistently, and the inflation rate fell from above 20% in 1974 to about 0 to 2% in the eighties. Growth of government spending was tightly controlled, so government spending and the budget deficit declined as a share of GNP. A period of stable growth with no recessions followed. During most of the past eight years, growth of real output remained between 3 and 5 per cent annually.

The Federal Reserve concentrated mainly on domestic interest rates, free reserves and member bank borrowing under both fixed and fluctuating exchange rates. Typically the Federal Reserve ignored the announced targets for money growth, just as it had ignored its commitment to pursue policies consistent with the fixed exchange rate regime in the sixties. Shifting and ambiguous policies based on changing current conditions and forecasts of future conditions left a residue of skepticism. Although inflation declined in the eighties, the annual growth rate of output fluctuated between -2 and 6 percent. Short spurts of relatively fast growth were followed by recessions or periods of slow growth. Fiscal policy changed frequently and contributed to uncertainty.

Differences in the stability of policy are a principal reason for the observed differences in the variability of output and prices and the differences in the size of forecast errors. The comparative experience of Japan and the United States in recent decades suggests that stable policies reduce variability and uncertainty. That experience also suggests that, contrary to often repeated statements about the fluctuating exchange rate system, Japan experienced less variability of prices and output under the fluctuating rate regime.

Conclusion

The comparison of Japan and the United States is like the evidence from an experiment. Both experienced similar shocks. Both reduced inflation, Japan more successfully than the United States. Although Japan started with a higher rate of inflation, it ended with a lower average rate, and Japan avoided the recessions that affected the U.S. and others in the 1980s. Japan
was able to reduce uncertainty about output from above the level in the United States under fixed exchange rates to below the level of the United States, on average, for the past ten years of monetary announcements and fluctuating exchange rates.

There are two main lessons from this experiment. First, fluctuating exchange rates only contribute to stability if policies are stabilizing. U.S. policy will enhance stability when it is more certain and more predictable. Second, both the U.S. and the rest of the world have much more to gain from reforms that increase certainty, credibility and the reliability of policy than from reforms that try to fix or coordinate exchange rates.